SUPREME COURT, U. S.
Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1076

HARRY A. SKYDELL and ARNOLD DUTCHEN,

Petitioners,

—against—

ECOLOGICAL SCIENCE CORPORATION, *et al.*,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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ECOLOGICAL SCIENCE CORPORATION, *et al.*,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioners pray that a writ of *certiorari* issue to review the judgment entered on October 31, 1975, by the United States Court of Appeals for the Fifth Circuit, which judgment affirmed a judgment of the United States District Court for the Southern District of Florida dismissing a consolidated action which was commenced as a class action under Rule 23 of the Federal Rules of Civil Procedure for alleged violations of the federal securities laws. The dismissal was based on a purported stipulation of settlement which provided for the voluntary withdrawal of a petition for certiorari, seeking review of a denial of class action certification, in return for a pay-off to the named plaintiffs.

Opinions Below

The opinion of the United States Court of Appeals for the Fifth Circuit, filed October 31, 1975, has been officially reported as *Carl M. Pearson, et al.,* plaintiffs v. *Harry A. Skydell and Arnold Dutchen,* plaintiffs-appellants v. *Ecological Science Corporation, et al.,* defendants-appellees, 522 F.2d 171. A copy thereof is set forth in Appendix "A" hereto. There was no opinion of the United States District Court for the Southern District of Florida upon which its judgment of dismissal was based, but its findings were set forth in an order dated March 28, 1974 which is set forth in Appendix "B" hereto. The district court's judgment of dismissal is set forth in Appendix "C" hereto.

Jurisdiction

The judgment of the Court of Appeals was entered on October 31, 1975. Petitioners herein timely petitioned to the Court of Appeals for the Fifth Circuit for a rehearing *en banc,* which petition was denied by Order dated December 24, 1975. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

Questions Presented

1. Whether named plaintiffs, in an action brought by them as a class action, can validly discontinue the action during a pending appeal from a denial of class action certification, thereby sacrificing the rights of the class, in exchange for a private pay-off.

2. Whether it is necessary to review the propriety of an interlocutory order denying class action status, upon appellate review of a final order, dismissing the action, which could not possibly have been proper if class action status had been granted because the dismissal did not provide notice or benefit to the members of the class as required in class actions by Rule 23(e) of the Federal Rules of Civil Procedure.

3. Whether a judgment dismissing a derivative action, without notice or benefit to the shareholders, in violation of Rule 23.1 of the Federal Rules of Civil Procedure, may be permitted to stand upon Appellate review merely because the violation was not brought to the lower court's attention.

4. Whether a plaintiff's acceptance of a settlement of his claims is valid when he was induced to provide such acceptance by misrepresentations including, *inter alia,* a misrepresentation that his attorney was aware of and had approved of the settlement.

5. Whether a settlement is binding when it provides, as a condition precedent, that all plaintiffs must accept the settlement and three of the plaintiffs do not accept.

Statutes Involved

Rule 23(a) of the Federal Rules of Civil Procedure provides:

> "*Prerequisites to a Class Action*: One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2)

there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class."

Rule 23(b)(3) of the Federal Rules of Civil Procedure provides:

"*Class Actions Maintainable*: An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition: (3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interests of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action."

Rule 23(c)(1) of the Federal Rules of Civil Procedure provides:

"As soon as practicable after commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained. An order

under this subdivision may be conditional, and may be altered or amended before the decision on the merits."

Rule 23(e) of the Federal Rules of Civil Procedure provides:

"*Dismissal or Compromise.* A class action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs."

Rule 23.1 of the Federal Rules of Civil Procedure provides in relevant part:

"*Derivative Actions Brought by Shareholders* . . . The [derivative] action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs."

Federal securities laws involved in this case are §§27 and 10b of the Securities Exchange Act of 1934 (15 U.S.C. 78aa and 78 jb); SEC Rule 10b-5 (17 C.F.R. 240.10b-5); §§22(a), 15 and 17(a) of the Securities Act of 1933 (15 U.S.C. 77 v(a), o and q(a)); §§13(a), 14(a) and 20 of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a), n(a) and t); and SEC Rules 13a-1, 13a-11 and 13a-13 (17 C.F.R. 240.13a-1, -11 and -13). These are set forth in Appendix "D" hereto.

Statement of the Case

The action is a consolidation of sixteen class actions commenced throughout the United States by purchasers of common stock of Ecological Science Corporation ("Ecological"), a publicly held corporation. The plaintiffs allege a conspiracy by the defendants to manipulate and artificially inflate the price of the common stock of Ecological in violation of the federal securities laws.* The action also includes a derivative claim by plaintiffs for violations of the securities laws* involving misappropriations by the defendants (other than Ecological) of valuable subsidiaries of Ecological (A** 76-78). The jurisdiction of the district court was invoked because federal statutes were involved, including the Securities Exchange Act of 1934 which provides for exclusive federal jurisdiction, and diversity was claimed as to some of the plaintiffs. In addition jurisdiction was based upon the principles of pendent jurisdiction.

The district court denied class action status even though: (1) the defendants had admitted in prior proceedings that "there is no escape from having the [consolidated action] proceed as a class action" (A 53); (2) the district court had indicated in prior orders that the litigation would proceed as a class action (A 4); and (3) at the hearing on the class action motion, the district court noted that all defendants had previously agreed to class certification (A 171). Co-lead counsel for plaintiffs ("co-lead counsel") appealed the denial of class status to the United States Court of Appeals for the Fifth Circuit (the "Court of Appeals"). That appeal was dismissed solely on the

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* The federal securities laws involved are cited on page 5 hereof.

** "A" Refers to the Appendix on Appeal in the Fifth Circuit.

grounds that the denial of class status was not a final order, and co-lead counsel petitioned for *certiorari*. Throughout the litigation on the class action motion, co-lead counsel vigorously pressed that this is a classic case for granting class action status.

While the petition for *certiorari* was pending, co-lead counsel inexplicably entered into a stipulation of settlement with the defendants pursuant to which the *named* plaintiffs and intervenors would obtain a 100% recovery of their claims and the unnamed members of the class would receive nothing.* The stipulation also provided that the petition for *certiorari* would be withdrawn, rendering the settlement, in effect, a sale by named plaintiffs of the right to appeal from an adverse class status decision in consideration of a private settlement for their benefit at the expense of the class.

Upon the filing of the stipulation, the district court took an action unparalleled in the history of Federal class actions: it approved the settlement, dismissing the action with prejudice, but sealed the stipulation so that no one but the parties knew its terms. Moreover, the stipulation itself contained a highly unusual term—it provided for the *removal of most of the documents from the court file, and for the sealing of the remainder of the file.* The district court provided no notice of the dismissal to the members of the class, and no notice to shareholders of the dismissal of the derivative claim as required under FRCP 23.1.

Although the order appointing co-lead counsel required them to enter into stipulations "subject to consultation by

* While less than 100 claimants were made whole, 16,000 members of the class were abandoned by this maneuver.

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them with additional counsel representing specific plaintiffs," co-lead counsel wrote directly to the Petitioners for their consent to the stipulation of settlement without first discussing the matter with their attorneys and without their attorneys' knowledge. The Petitioners consented to the stipulation only because they were misled by co-lead counsel into the erroneous belief that their individual attorneys knew and approved of the settlement, and because of numerous other gross misrepresentations contained in the presentation of the settlement sent to them by co-lead counsel. In fact, the appellants' individual attorneys knew nothing of the settlement until after it was consented to by the appellants, and advised their clients that the settlement was improper promptly after learning of it. Petitioners then sought to revoke their consents to the stipulation and appealed to the Court of Appeals from orders of the district court enforcing the stipulation and dismissing the action (A 51, A 161-62, A 186, A 185, A 211, A 190).

The stipulation of settlement expressly provided that it was subject to the granting of consent thereto by all of the individual plaintiffs. However, no consent whatsoever was obtained from three of the plaintiffs (Frederick Marks, Leonard Shwade and Esther Schwade). Because of co-lead counsels' desire to terminate the action, on February 22, 1974 they purported to entirely waive the condition of obtaining authority, with respect to those plaintiffs, and thereby materially altered the terms of the stipulation. The "consents" from the Petitioners, however, had been returned prior to such material alteration and, therefore, could not have been consents to the stipulation as subsequently altered (A 180, A 217).

The Court of Appeals affirmed the judgment of the district court. It recognized no wrong in what Petitioners submit is a private sale of appeal rights from an adverse class determination, refused to consider that the action contained a derivative claim which was settled with no notice to the shareholders and no benefit to the corporation, refused to review the denial of class status solely because the dismissal order was affirmed, and honored the stipulation even though the Petitioners consent had been obtained through misrepresentations and consents of other plaintiffs had not been obtained at all.

The issues involved are sufficiently important to have drawn the Securities and Exchange Commission ("SEC") into the case as *amicus curiae*. The SEC submitted a brief and a reply brief supporting the Petitioners, and a brief in support of Petitioners' motion for a rehearing *en banc*.

REASONS FOR GRANTING THE WRIT

POINT I

The decision of the Court of Appeals sanctions private settlements and the sale of rights of appeal by named plaintiffs in a class, at the expense of class members, in breach of plaintiffs' fiduciary duties and contrary to a decision of this Court.

The panel attempted to explain away the applicable Supreme Court decision, *Young* v. *Higbee Co.*, 324 U.S. 204 (1944). We submit that this was a fundamental error, on an important question of federal law, which is in conflict with this Court's prior decision.

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In *Young,* the Supreme Court outlawed the sale by named plaintiffs of the right to appeal from what amounted to an adverse class decision. There, plaintiffs who represented a class, but who settled for their own benefit and dismissed their appeal on behalf of the class, were liable to the class. The Court held that, by availing themselves of the privilege of litigating for a class, the named parties had assumed the duty to represent the rights of the class fairly and in good faith and to refrain from trading in the rights of others for their own private benefit.

In *Young,* the plaintiffs were two preferred shareholders appealing from the district court's approval of a bankruptcy reorganization plan which failed to subordinate a debt claim to the rights of the preferred class. The Court of Appeals, in seeking to distinguish *Young,* stated that *Young* is not applicable to conventional class actions, but only where the class members are bound to the decision under the principles of *res judicata* (522 F.2d at 178) (8a).* However, this is contrary to what the Supreme Court actually suggested in *Young.*

The leading article on settlement of stockholders' actions, Haudek, *Settlement and Dismissal of Stockholders' Action,* 22 S.W.L.J. 767, 788-9 (1968) and 23 S.W.L.J. 765 (1969), correctly states that the Supreme Court intended the *Young* doctrine to apply to conventional class suits, i.e., where the dismissal is *not res judicata* upon the class (235 S.W.L.J. at 817). In support, Haudek cites footnote 10 of the *Young* decision, 324 U.S. at 204, which refers to articles by McLaughlin and Hornstein as dealing with "the same general topic," notwithstanding that such articles deal with stock-

* "a" refers to the appendix hereto.

holders' private settlements in conventional class suits where *res judicata* is not a factor. Haudek further states that this application is now beyond doubt, citing *Certain-Teed Prods. Corp.* v. *Topping,* 171 F.2d 241 (2nd Cir. 1948); *Miller* v. *Steinbach,* 268 F. Supp. 255, 281-83 (S.D. N.Y. 1967); *Craftsman Fin & Mortgage Co.* v. *Brown,* 64 F. Supp. 168, 178 (S.D.N.Y. 1945) (dictum). Indeed, a finding that the named plaintiffs cannot sell the right to appeal is even more imperative in the instant action, where the plaintiffs initiated the action in behalf of a class, than in *Young* where the plaintiffs initiated the action only in their own names.

The Court of Appeals was particularly concerned that settlement of non-class actions would be hobbled by adoption of appellants' position; it stated:

> "The rule which appellants ask this court to adopt would require that in every action in which class action certification is denied by a district court, the named plaintiffs would be precluded from executing a settlement of their individual claims, and would be required to litigate through appellate review of the interlocutory order denying class action certification after final judgment in the trial court" (522 F.2d at 177) (7a).

However, the rule sought by the Petitioners would not require litigants in a class action to appeal every denial of class action status, but would restrain plaintiffs from *discontinuing an appeal they had already commenced,* upon a settlement which provides them a full recovery at the expense of the class. It is the sale of rights of an appeal already commenced that was precluded by the Supreme

Court in *Young Higbee,* and it is the sale of such rights which the Petitioners sought to prevent herein but which was sanctioned by the Court of Appeals.

The Court of Appeals also stated that the members of the class would not be prejudiced because they could commence their own actions despite the dismissals of the instant action (522 F.2d at 178) (8a). This is simply not correct. Any party commencing a new action would face the obstacle of defenses based upon the statute of limitations and upon laches which, if not absolutely insurmountable, would at least burden the plaintiff with serious issues not present in the instant action. Although the Court of Appeals stated that recent decisions by the Supreme Court indicate that *"at least in certain situations"* the commencement of a class action tolls the applicable statute of limitations (522 F.2d at 178) (8a), the applicability of such cases to the instant situation is far from clear. A plaintiff in a new action would have the burden of showing that the toll applies in his situation, and would have to face threshold litigation pertaining to the statute of limitations. In any event, these recent cases do not even address the defense of laches. Moreover, as pointed out by the SEC, in its brief, the class members are not receiving notice of the dismissal and many will, therefore, be unaware of the need to commence an action for themselves. In addition, the enormously expensive discovery heretofore had in this action will have to be repeated in any new action. Finally, the additional time might permit the dissipation of defendants' assets and hamper collection of any judgment against them, and might cause a lapse of any available insurance coverage.

If the Court of Appeals' decision is allowed to stand, the Fifth Circuit will have paved the way for the frequent and common occurrence of private settlements between parties in class actions which would (1) permit corporate fiduciaries to pay but a relatively nominal sum for violations of their fiduciary duty, and (2) make a complete mockery of the requirement that members of a class have adequate representation. Because of the impact that the occurrence of such private settlements would have on the business and investment communities, and because of the failure to follow the teachings of *Young* v. *Higbee,* Petitioners respectfully urge that *certiorari* be granted.

POINT II

By refusing to review the district court's denial of class action status, the Court of Appeals held that interlocutory orders which affect the final determination are not reviewable upon an appeal from a final determination, a gross departure from the accepted and usual course of judicial proceedings.

The Court of Appeals refused to review the denial of class action status despite the fact that this is an appeal from a final judgment. It stated that it was "unnecessary to determine the propriety of the class denial inasmuch as we affirm the order of the district court enforcing the settlement and dismissing the action" (522 F.2d at 179) (9a). However, the district court's denial of class action status *necessarily* affected the validity of the judgment dismissing the action. Had class status been granted, instead of denied, the dismissal judgment would never have been allowed to stand because it would have dismissed a proper class

action without any notice or benefit to the members of the class in violation of Rule 23(e) of the Federal Rules of Civil Procedure. Moreover, upon earlier appeal, immediately following denial of class action status, the Court of Appeals had ruled the order was interlocutory and not then appealable. Now, however, it has ruled that the order cannot be reviewed upon a review of the final determination. These two refusals to review class status determination leads to one conclusion: class action status will not be reviewed in the Fifth Circuit—a fundamental departure from the accepted and usual course of proceedings and a violation of the Federal Rules of Civil Procedure.

Before this decision, it has always been held that interlocutory orders, which were not immediately appealable, and which affected the final determination, were reviewable upon an appeal from a final decision. *Atchison T&SF Ry. Co.* v. *Jackson,* 235 F.2d 390; *Skirvin* v. *Mesta,* 141 F.2d 668, 671 (10th Cir. 1944); *Western Union Telegraph* v. *United States & Mexican Trust Co.,* 221 F. 545, 551 (8th Cir. 1915). The Court of Appeals' decision, contrary to the decisions of the other circuits, has made appellate review of an adverse class status determination impossible to be had at anytime. It has held that an interlocutory order is not reviewable immediately or upon an appeal from the final determination even when the interlocutory order directly affects the validity of that final determination.

POINT III

By refusing to consider that the district court approved a dismissal of a derivative action, in violation of FRCP 23.1, on the grounds that the issue had not been raised in the lower court, the decision of the Court of Appeals is in conflict with other circuits and other decisions of the Fifth Circuit, and creates a miscarriage of justice by its gross departure from the accepted and usual course of judicial proceedings.

The Court of Appeals refused to recognize that the district court approved a dismissal of a derivative action (which provided no benefit to the corporation) without notice to the corporation's shareholders in clear violation of Rule 23.1 of the Federal Rules of Civil Procedure. The Court of Appeals reasoned that the issue had not been raised in the court below (522 F.2d at 179) (9a). Yet, the dismissal involved (1) a gross miscarriage of justice, (2) a clear error on the face of the pleadings and record, and (3) no factual dispute. Under these circumstances, the Court of Appeals has departed from the settled rule of its Circuit and other circuits.

By permitting a dismissal of a derivative action with no benefit to the corporation, and no notice to its public shareholders, a gross miscarriage of justice was done in violation of the policy set forth in the securities laws and in the notice provision of Rule 23.1 of the Federal Rules of Civil Procedure. Appellate courts have consistently considered errors where such gross miscarriages of justice result, regardless of whether the error was raised in the court below. *Nello* v. *John B. Kelly, Inc.*, 283 F.2d 96, 101

(3rd Cir. 1960); *Boufford* v. *U.S.*, 239 F.2d 841, 842 (1st Cir. 1956); *Mulligan* v. *Andrews*, 211 F.2d 28, 29 (D.C. Cir. 1954); *U.S.* v. *353 Cases Mountain Val. Mineral Water*, 247 F.2d 473, 477 (8th Cir. 1957); *Fleming* v. *Goodwin*, 165 F.2d 334, 337 (8th Cir. 1948), *cert. denied*, 334 U.S. 828; *Chicago, B&QR. Co.* v. *City of North Kansas City, Mo.*, 276 F.2d 932, 939 (8th Cir. 1960); *Petty* v. *Porter*, 322 F.2d 308, 311 (6th Cir.), *cert. denied*, 377 U.S. 948 (1963).

Where the lower court's error is obvious and clear from the face of the pleadings or record, appellate courts, including the Fifth Circuit, have corrected the error although not raised below. *Benson* v. *U.S.*, 112 F.2d 422, 423 (5th Cir. 1940); *Boire* v. *Miami Herald Publishing Company*, 343 F.2d 17, 25 (5th Cir.), *cert. denied* 382 U.S. 824 (1965); *Gomila* v. *U.S.*, 146 F.2d 372, 376 (5th Cir. 1944); *U.S.* v. *Kadison*, 145 F.2d 525, 526 (7th Cir. 1944); *Trussell* v. *U.S.*, 278 F.2d 478, 480 (6th Cir. 1960). In *Boire*, the Fifth Circuit held that where the record did not present questions involving resolutions of any factual disputes and the error was clear, the appellate court would examine the question even though the district court had not considered it. In the instant action, the error is clear, involves no factual disputes and is indisputable on the face of the record. It is not open to question that notice required by Rule 23.1 of the Federal Rules of Civil Procedure was not given, and that a derivative claim was involved.

In refusing to consider the error made by the district court in dismissing the derivative action in violation of Rule 23.1, the Fifth Circuit stands alone in the promulgation of a rigid doctrine that issues not raised below will *never* be heard upon appeal no matter what the circumstances.

POINT IV

By affirming the stipulation procured through misrepresentations and without the occurrence of a condition expressed therein, the decision of the Court of Appeals has decided basic contractual issues in conflict with state law.

It is an elementary rule of the law of contracts that any acceptance of an offer, induced by fraud or misrepresentation in representing the material terms of the offer, is void or voidable (Corbin on Contracts, §6 (1 Volume ed.); Simpson on Contracts, §7 (2nd Edition). Co-lead counsel obtained the consents of the petitioners to the stipulation through blatant misrepresentations by falsely implying that their attorneys had knowledge of and had approved the settlement. Letters from co-lead counsel to petitioners, requesting their consent, stated that their attorneys would participate in a specific fee, thereby indicating that they had previously agreed to such participation and had been kept abreast of settlement developments (A 185, A 194). The letters also indicated that carbon copies thereof were being sent to their attorneys making it appear that they had been previously consulted (A 195). However, delivery of the copies to petitioners' attorneys had been delayed and were not received until after the consents were procured.

The letters to the petitioners seeking their consent contained further misrepresentations relied upon by the petitioners in granting their consent (A 188-190). In view of the foregoing, the petitioners' consents were procured through material misrepresentations and, thus, their revocations were effective and the stipulation failed.

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Although it was not contested that three plaintiffs besides the petitioners had not consented to the stipulation, and that the stipulation expressly required that all of the plaintiffs consent as a condition precedent thereto, co-lead counsel purported to waive the requirement of obtaining the consent of those plaintiffs whose consents had not been obtained. However, if by this unilateral act, co-lead counsel did effectively waive the necessity of obtaining three missing consents, they materially altered the terms of the stipulation, i.e., by changing the requirement that consent from all of the plaintiffs and intervenors be obtained. The consents from petitioners, however, were procured prior to such waiver and, therefore, were to the unaltered stipulation and could not have been effective as an acceptance of the subsequently altered version that did not require all consents.

CONCLUSION

For the reasons set forth above, petitioners pray that a writ of certiorari issue to review the judgment of the Court of Appeals for the Fifth Circuit.

Dated: January 28, 1976

Respectfully submitted,

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